Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Chavez Analyst: Jeff Garnier Bill Number: AB 1338

Related Bills: See Prior Analysis Telephone: 845-5322 Amended Date: April 22, 2003

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Withholding on California Real Estate to 9.3%

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______________________.
X	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
____	AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ______________________.
____	FURTHER AMENDMENTS NECESSARY.
____	DEPARTMENT POSITION CHANGED TO ______________________.
X	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 21, 2003, STILL APPLIES.
____	OTHER - See comments below.

SUMMARY

This bill would:

- Modify the real estate withholding provisions so the withholding amount more closely matches the actual tax due on the sale of the property,
- Broaden the principal residence withholding exemption to include the sale of a residence that was last used prior to the sale as the taxpayer's principal residence, and
- Exempt from withholding the sale of real property sold by licensed general contractors if the property was held for sale as inventory in the taxpayer's construction business.

SUMMARY OF AMENDMENTS

The April 22, 2003, amendments removed the provisions that would have:

- Required withholding on the (gains in excess of $250,000 for individual taxpayers and $500,000 for married, filing jointly, from the sale of a principal residence).
- Made the penalty for failure to properly withhold jointly and severally the liability of the buyer and the real estate escrow person (REEP). The current law liability of the penalty remains with the buyer.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP	Brian Putler	4/25/03
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The April 22, 2003, amendments added the provisions that would:

- Broaden the principal residence withholding exemption to include the sale of a residence that was last used prior to the sale as the taxpayer's principal residence, irrespective of the length of time it was so used, and
- Exempt from withholding the sale of real property sold by licensed general contractors if the property was held for sale as inventory in the taxpayer's construction business.

The remainder of the analysis of the bill as introduced on February 21, 2003, still applies.

POSITION

Pending.

ANALYSIS

CURRENT STATE LAW

Current state law requires withholding on the sale of a residence if the residence is not the seller's principal residence within the meaning of Internal Revenue Code (IRC) Section 121. IRC Section 121 requires a taxpayer to own and use the residence as the taxpayer's principal residence for at least two of the five years immediately preceding the sale to qualify for the exclusion of the gain from the sale of the residence.

THIS BILL

This bill would:

- Allow the seller to elect to have the maximum tax rate (presently 9.3% for individuals and trusts and 8.84% for corporations) of the gain withheld instead of $3^{1/3}$% of the sales price. The seller must certify under penalty of perjury that gain reported to the buyer or (REEP) is correct.

- Exempt from withholding the sale of a residence if the residence was last used by the seller as the seller's principal residence, without regard to the amount of time the residence was used by the seller as a principal residence. Thus, a residence sold by a taxpayer used by the taxpayer as the his or her principal residence for less than two of the five years immediately preceding the sale would be exempt from withholding. The seller would be required to certify, under penalty of perjury, the above is correct.

- Exempt from withholding the sale of any real property held as inventory by a licensed general contractor operating as a sole proprietor. The seller would be required to certify that he or she is a licensed general contractor and that the property was held for sale in the ordinary course of his or her business (inventory) of constructing and selling real property.

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- Revise the withholding requirements on corporations with no permanent place of business in California to match the requirements for individuals. This eliminates the corporation waiver process and replaces it with the same statutory scheme in present law for self-certification by individuals.

- Remove a law provision that prohibits a penalty from being assessed (would now allow the penalty) on the REEP for failure to properly withhold if the seller reports the gain on the sale of the property and pays the proper amount of tax by the due date or extended due date of the tax return.

- Clarifying expressly that transfers of real property will not be subject to withholding if they are contributions to capital of controlled corporations and partnerships, sales by estates of a decedent's principal residence, or other sales that do not result in a net recognized gain

ECONOMIC IMPACT

Tax Cash-Flow Estimate:

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of AB 1338 As Proposed to be Amended April 16, 2003 Effective for tax years BOA 1/1/2003 Enacted after 6/30/2003 $ Millions			
	2003-04	2004-05	2005-06
3.3% W/H or 9.3% on Gains	-$30	-$3	-$3
Exempt Selected Residences	-$1	Minor loss+	Minor loss+
Exempt Schedule C General Contractors	-$1	Minor loss+	Minor loss+
Total	-$32	-$3	-$3

* Ultimate tax liabilities are not affected, only the timing of payments.
+ Less than $250,000.

Cash-flow Estimate Discussion

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

The cash-flow impact for the first item was estimated as follows. The cash flow reductions due to withholding at the lower of 3.3% of the sales price or 9.3% of net capital gains were estimated based on the department's 1999 and 2000 capital gains samples. The 1999 and 2000 reductions were extrapolated to 2003 using projected growth rates of residential sales. The cash-flow impact is estimated as the average of these two cash-flow losses.

The second provision to exempt from withholding on selected personal residences was derived as follows. First, the sales of the residences that do not meet the two-year live-in requirement of a principal residence in 2000 were estimated using the department's personal income tax sample. Next, the sales of second and vacation homes were estimated. These sales amounts are extrapolated to 2004 based on the projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified sales. This gross amount is adjusted downward for the qualifying amount, fiscal year differences, offsetting estimate/withholding payments under current law, and other prepayments.

The last provision to exempt from withholding Schedule-C general contractor was derived as follows. First, the gross receipts of all sole proprietors with North American Industry Classification System (NAICS) code of 233200 (residential building construction) in 2000 were estimated using the department's personal income tax sample. This amount is extrapolated to 2004 based on projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified amount. This gross amount is adjusted downward for qualifying amount, fiscal year differences, offsetting estimate payments under current law, and other prepayments.

The cash-flow impact of AB1338 for fiscal year 2003/04 is estimated to be a cash-flow loss of $32 million. This cash-flow loss is largely a one-time event. The term "cash-flow" loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

LEGISLATIVE STAFF CONTACT

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